Financial Institutions 4th Quarter 2018 Strategy

October 17, 2018 | Institutional Investment Management

Key Takeaways

- The economy remains strong.
- We do not expect the yield curve to invert until 2019 and it's unlikely we have the means of a meaningful recession in the next 12 months.
- Credit will become more costly as the Fed continues to gradually raises interest rates.
- U.S. politics and international trade will continue to be drags on the economy.

Patrick Larson
Principal, Director of Institutional Investment Management

866.225.5224 Toll Free
612.230.3019 Fax
50 South 6th Street
Suite 975
Minneapolis, MN 55402

Economic Overview

The economy is growing at a remarkable pace. Second quarter GDP increased 4.2% and the 3rd quarter may also exceed 4.0%. It seems likely 4th quarter GDP will be between 3.0% and 3.5%. Up to this point, the Fed seems to have gotten both the pace and timing of this tightening cycle right. There have been no major market reactions to any of the Fed rate hikes this year. Instead, we have seen slowly increasing interest rates and generally low volatility in the equity market. Consumer confidence is at an 18-year high and inflation remains near 2.0%. Equity markets have increased 4% - 10% this year which makes consumers feel better off.

One worry investors point to frequently is the flattening yield curve and the potential for an inversion. Yield curve inversions tend to precede recessions (frequently, but not always) which is the reason investors pay attention to this barometer of economic expectations. The yield on the 10-year Treasury is only 25 basis points higher than a 2-year Treasury note. Last year this spread was 80 basis points.

We don't expect the yield curve will invert until next year. It's unlikely we have the makings of a meaningful recession in the next 12 months. The economy has significant momentum and severe excesses like we had 10 years ago are generally not broadly present.

"A strong economy, with a flattening yield curve and the uncertainty of the midterm elections. What does it mean for fixed income investors?"

A strong economy, with a flattening yield curve and the uncertainty of the midterm elections. What does it mean for fixed income investors? We believe it means the Fed will continue to gradually increase short term interest rates. Barring a surprise increase in inflation or unexpected election results, Treasury rates will likely move higher in a gradual manner, yet our expectation is for a continually flattening yield curve which may reach an inverted state. Intermediate investment yields may approach 4.0% on some residential mortgage backed securities. Demand would be robust since investors haven't seen such yields in roughly a decade.

Our Recommendations

Last quarter we encouraged clients to look at selling some shorter bonds and reinvest in the 10 to 15-year area, taking advantage of the tremendous demand for shorter munis and to add yields that were roughly 150 basis points higher than the bonds that were sold. The relative steepness of the muni yield curve as compared to the Treasury curve places the best opportunity to add yield in bonds with maturities beyond the 10-year area. Looking forward, we see longer muni yields as being very appealing for S-Corp banks, especially those who enjoy Federal and state tax-exemption on municipal bonds issued in their state of residence. As an example, for S-Corps, high-quality (investment grade) muni bond yields of 3% to 3.75% in the 10 to 15-year area may translate into taxable equivalent yields of between 4.6% and 6.8%. At the high end of that range, the taxable equivalent yields are equivalent to that of corporate "junk" bonds. When we look at the opportunities in the fixed income markets an area of interest remains with longer municipals. Many investors won't go longer than a 10-year maturity. This naturally benefits investors willing to consider relative value opportunities offered by buyer segmentation preferences and the shape of the various yield curves. Less demand can mean it's easier to find product and the relatively steep municipal yield curve provides a significant increase in yield. It is also important to remind readers that the municipal market values tend to not be as volatile as taxable bonds. Historically they change about 70% as much as a like term taxable bond.

For a more global recommendation, we suggest that from this point until rates peak, your purchases have some form of call protection or prepayment protection. Callable agency bonds give the buyer a slightly higher yield upfront but grant the issuer the option to call it in the future. Giving someone else the right to call it isn't often worth the additional yield. You are likely much better off buying securities having call or prepayment protection such as 15-year low-loan-balance mortgage backed securities. There is also prepayment protected mortgages based on the composition of servicers and states in which the mortgages were originated. The cost, versus bonds without this prepayment protection, is very small. We also like 20-year MBS that have a 6.0-year average life and a yield close to 3.75%. Agency-backed commercial mortgage backed securities also have excellent call protection. It's much easier to manage portfolio book yield stability and net interest income durability with greater cash flow predictability than is the case with volatile cash flows

"For a more global recommendation, we suggest that from this point until rates peak, your purchases have some form of call protection or prepayment protection."

While it's been a difficult year for total return investors, those who rely on book yield and book income have welcomed higher rates. The economy has accelerated as the year progressed and the Fed has been very transparent. This has resulted in generally lower volatility and an expectation of continued strong growth. Politics, tariffs and the mid-term election have the potential to change this relatively tranquil environment very quickly. Our forecast for the 4th quarter is GDP close to 3.5%, slightly higher interest rates, and a 4th rate hike by the Fed. We favor longer term municipals and call protected securities including low loan balance MBS and agency backed CMBS.

Interest Rate Outlook – The Details

Our primary concern that requires a bit more investigation is that the lubricant for the economy, credit, is becoming more expensive. The more obvious and possibly imminent influences involve international trade and the political landscape. Clearly the headlines in the 3rd quarter were centered on the signs of economic strength and the threat to growth that a trade war represented. As the quarter ended, a proposed North American trade agreement (the U.S. – Mexico-Canada Agreement, or USMCA) assuaged some of the related fears. Now, China remains the great unknown. As we have speculated in the past, China will be the most difficult negotiation and our belief is that the eventual agreement will be a hollow win for the United States. Soon, China will be consistently the largest economy in the world and they play the long game. As such, we expect they will wait until after the mid-term elections to decide a path of negotiation that best achieves their desired outcome.

If we dissect the second quarter GDP number (released in Q3) things are pretty good. Much of the 4.2% rate of growth came from exports and growth in both consumer and business demand. The influence from exports may be a fleeting force, since there was a rush to ship agricultural and petroleum products ahead of the threat of retaliatory tariffs. Household consumption, which accounts for roughly 70% of GDP, is growing by 4%. This should be a more durable influence on growth as the unemployment rate is near the lowest it has been since 1969 and real wages are growing at 2.6%. We expect that the powerful growth numbers exhibited by businesses may be a bit less reliable. Non-residential business spending increased by 7.3%, but that may still be a diminishing contributor over time as the impact of tax cuts should have a half-life and political changes may influence both business investment appetite and their forecast for consumer demand.

Considering the recent bond market performance, we feel the need to repeat that last quarter we suggested averaging in to the market would likely be at times a bit frustrating. You may not have put your money to work at the top of the market yields, but over time, the yields should prove to be attractive. We also said investors might get a second bite at the yields we saw in May. For added perspective, yields on the 10-year Treasury hit 3.11% in May and we closed the 3rd quarter at 3.06%. As the 4th quarter has gotten underway, yields have spiked up to 3.23%. Although it certainly doesn't feel good to not hit the top (in terms of yield), we are only talking about 0.12% (or 12 basis points) above the levels we saw in May. Portfolio book yields are on the rise and that is a good development.

Our expectation is that politics will take center stage for the balance of the year and that the weight of higher borrowing costs will start to take their toll on economic growth expectations at a point in 2019. Depending on the market's interpretation of the political outcome of the mid-term elections, the two influences may combine to create a downward gravitational pull on market sentiment. As politics is a sensitive issue, it is important to state that our comments are through the lens of a bond portfolio manager and our views are not based on an outcome we are hoping for, they are based on the best available information we have gathered and are ideas on what the most likely outcome of the election may have on the market. One thing is for sure, polling information in the President Trump era is a bit less reliable than was the case in the past. The likely outcome of the mid-terms is that we will see an end to one-party control of Washington. There are roughly 60 Republican-held seats in play of the total 435-seat House of Representatives. Democrats need a net gain of 23 seats to flip control of the House. It seems like a pretty sound bet. The Senate is a different story. Democrats are defending 17 more Senate seats than Republicans and 10 of those seats are in states that President Trump won in 2016. We expect the most likely outcome will be that the Republicans will hold on to their slim majority in the Senate. The net result could be political gridlock. We anticipate that the market will view the US economic picture as being a bit less detached from moderating global growth expectations and the current investor sentiment that "trees can grow to the sky" will be tempered. The surprise outcomes would be if Republicans retain control of the legislative branch of government, investors will assume business spending will remain robust and that the trees will have more room to grow. If Democrats gain control of both the House and the Senate, discussions of impeachment would have more teeth and the uncertainty could drive growth expectations lower.

As the market weighs the impact of gridlock in Washington, continued uncertainty regarding global trade and the drag that higher borrowing costs may exact on both individual consumers and institutions, we envision a scenario where bond yields move from the peak. The International Monetary Fund (IMF) has cut its forecast for global growth in 2019 due to the trade dust-up between the US and China. If the "war" escalates, the IMF forecasts that it will reduce China's economic output by more than 1.6%, the US could see a 0.9% reduction in growth and global growth would slow by 0.8%. Concurrently, the Fed is expected to raise the Fed Funds rate again in December and roughly three times in 2019. Considering that the September hike took the Fed's stance to being neutral, and possibly to the point of being somewhat restrictive if you factor in the unwind of the Quantitative Easing Program, economic headwinds look to be imminent. Higher borrowing costs eat away at the disposable income of consumers and erode the anticipated breakeven point of investments contemplated by businesses. There is a reason why the Federal Open Market Committee has been using borrowing costs as a lever to influence the economy for nearly 85 years, it works. As the impact of higher borrowing costs permeates the economy, commonly used asset classes and investments (especially those that are levered and have demand elasticity) may see values fluctuate. We expect that in 2019 the weight of higher rates will cause economic sentiment to moderate. A sign we would encourage readers to watch for is if the Fed raises rates when the US Treasury yield curve is flat or inverted. Historically, once that occurs, there is a strong chance bond yields are headed lower (and often it precedes an economic slowdown).

"If the "war" escalates, the IMF forecasts that it will reduce China's economic output by more than 1.6%, the US could see a 0.9% reduction in growth and global growth would slow by 0.8%."

The Bloomberg Barclays Index that represents domestic high-quality corporate debt has lost 2.5% in 2018, and the index has only seen three years with negative returns since 1976. Unless you subscribe to the secular bond bear market outlook, we think mean-reverting influences will be a driver of bond market performance. Higher rates should attract more investors and therefore price stability. We like buying 10-year high-quality municipal bonds at yields above 3% and 15-year munis at yields close to 3.5%. Our target for the 10-year Treasury this year was that they would hit 3.10% and drift slightly lower by the end of the year. Election results and the weight of higher borrowing costs may make that prediction reasonable. There will be times you may regret not buying when yields were at their peak however, looking through the rear-view mirror, it may have been a good entry point.

Disclosure